

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68907; File No. SR-PHLX-2013-05)

February 12, 2013

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing of Proposed Rule Change Regarding Catastrophic Errors

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 31, 2013, NASDAQ OMX PHLX LLC (“PHLX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is filing with the Commission a proposal to amend Rule 1092, Obvious Errors and Catastrophic Errors. Specifically, Phlx proposes to amend Rule 1092(f)(ii) to permit the nullification of trades involving catastrophic errors in certain situations specified below.

The text of the proposed rule change is set forth below. Proposed new language is italics; proposed deletions are in brackets.

* * * * *

Rule 1092. Obvious Errors and Catastrophic Errors

The Exchange shall either nullify a transaction or adjust the execution price of a transaction that results in an Obvious Error as provided in this Rule.

(a) – (e) No change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(f) Catastrophic Error Procedure.

(i) Notification. If an Exchange member believes that it participated in a transaction that qualifies as a Catastrophic Error pursuant to paragraph (a)(ii) above, it must notify the Exchange's Regulatory staff by 8:30 am ET, on the first trading day following the date on which the Catastrophic Error occurred. For transactions in an expiring options series that take place on an expiration day, an Exchange member must notify the Exchange by 5:00 pm ET that same day. Relief will not be granted under this paragraph: (i) unless notification is made within the prescribed time period; and (ii) if an Options Exchange Official has previously rendered a decision with respect to the transaction in question pursuant to Rule 1092(e).

(ii) Catastrophic Error determination. An Options Exchange Official will determine whether the transaction(s) qualifies as a Catastrophic Error. If it is determined that a Catastrophic Error has occurred, the Options Exchange Official will adjust the execution price(s) of the transaction(s) according to subparagraph (f)(iii) below, as long as the adjusted price would not exceed the limit price of a non-broker-dealer customer's limit order, in which case the non-broker-dealer customer would have 20 minutes from notification of the proposed adjusted price to accept it or else the trade will be nullified. If it is determined that a Catastrophic Error has not occurred, the member requesting the determination will be subject to a charge of \$5,000.

(iii) – (iv) No change.

(g) No change.

Commentary: -----

.01 - .02 No change.

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposal is to help market participants better manage their risk by addressing the situation where, under current rules, a trade can be adjusted to a price outside of a customer's limit. Specifically, the Exchange proposes to amend Rule 1092(f) to enable a non-broker-dealer customer who is the contra-side to a trade that is deemed to be a catastrophic error to have the trade nullified in instances where the adjusted price would violate the customer's limit price. Only if the customer, or his agent, affirms the customer's willingness to accept the adjusted price through the customer's limit price within 20 minutes of notification of the catastrophic error ruling would the trade be adjusted; otherwise it would be nullified. Today, all catastrophic error trades are adjusted, not nullified, on all of the options exchanges.

Background

Currently, Rule 1092 governs obvious and catastrophic errors. Obvious errors are calculated under the rule by determining a theoretical price and determining, based on objective standards, whether the trade should be nullified or adjusted. The rule also contains a process for requesting an obvious error review. Certain more substantial errors may fall under the category

of a catastrophic error, for which a longer time period is permitted to request a review and for which trades can only be adjusted (not nullified). Trades are adjusted pursuant to an adjustment table that, in effect, assesses an adjustment penalty. By adjusting trades above or below the theoretical price, the Rule assesses a “penalty” in that the adjustment price is not as favorable as the amount the party making the error would have received had it not made the error.

Proposal

At this time, the Exchange proposes to change the catastrophic error process to permit certain trades to be nullified. The definition and calculation of a catastrophic error would not change.³ Once a catastrophic error is determined by Exchange staff, then if both parties to the trade are not a non-broker-dealer customer (“customer”),⁴ then the trade would be adjusted under the current rule. If one of the parties is a non-broker-dealer customer, then the adjusted price would be compared to the limit price of the order. If the adjusted price would violate the limit price (in other words, be higher than the limit price if it is a buy and lower than the limit price if it is a sell order), then the customer would be offered an opportunity to nullify the trade. If the customer (or the customer’s broker-dealer agent) does not respond within 20 minutes, the trade would be adjusted under the current rule.

These changes should ensure that a customer is not forced into a situation where the original limit price is violated and thereby the customer is forced to spend additional dollars for a trade at a price the customer had no interest in trading and may not be able to afford.

EXAMPLE 1 – Resting Customer forced to adjust through his limit price and would prefer nullification

³ Nor is the definition or process for obvious errors changing.

⁴ Professional customers are customers for purposes of Rule 1092. See Rule 1000(b)(x).

Day 1

8:00:00 am (pre-market) – Customer A enters order on PHLX to buy 10 GOOG May 750 puts for \$25 (cost of \$25,000, Customer has \$50,000 in his trading account).

10:00:00 am

GOOG trading at \$750

May 750 puts \$29.00-\$31.00 (100x100) on all exchanges

10:04:00 am

GOOG drops to \$690

May 750 puts \$25-\$100 (10x10) PHLX

May 750 puts \$20-\$125 (10x10) CBOE

May 750 puts \$10-\$200 (100x100) on all other exchanges

10:04:01 am

Customer B enters order to sell 10 May 750 puts for \$25 (credit of \$25,000)

10:04:01 am

10 May 750 puts execute at \$25 (\$35 under parity)⁵ with Customer A buying and Customer B selling.

10:04:02 am (1 second later)

GOOG trading \$690

May 750 puts \$75-\$78 (100x100) PHLX

May 750 puts \$75-\$80 (10x10) CBOE

May 750 puts \$70-\$80 (100x100) All other exchanges

⁵ Parity is the intrinsic value of an option when it is in-the-money. With respect to puts, it is calculated by subtracting the price of the underlying from the strike price of the put. With respect to calls, it is calculated by subtracting the strike price from the price of the underlying.

No obvious error is filed within 20 minute notification time required by rule. If this had been an obvious error review, the trade would have been nullified in accordance with Rule 1092 because one of the parties to the trade was a non-market maker.

4:00:00 pm (the close)

GOOG trading \$710

May 750 puts \$60-\$63 (100x100) PHLX

May 750 puts \$55-\$70 (10x10) CBOE

May 750 puts \$50-\$70 (100x100) All other exchanges

Day 2

- 8:00:00 am (pre-market)

Customer B, submits S10 GOOG May 750 puts at \$25 under Catastrophic Review.

Trade meets the criteria of Catastrophic Error and is adjusted to \$68 (\$75 (the 10:04:02 am price less \$7 adjyment penalty).

9:30:00 am (the opening)

GOOG trading \$725

May 750 puts open \$48.00-\$51.00 (100x100) on all exchanges

Under current rule:

Without a choice, Customer A is forced to spend \$68 (cost of \$68,000, with only \$25,000 in his account)

Puts are now trading \$48, so Customer A shows a loss of \$20,000 (\$68 less \$48x10 contracts x 100 multiplier)

Under proposed rule:

Customer A would be able to choose to have the B10 GOOG May 750 puts nullified avoiding both a loss, and an expenditure of capital exceeding the amount in his account. Customer B would be relieved of the obligation to sell the puts at 25 because the trade would be nullified.

EXAMPLE 2 – Resting Customer trades, sells out his position, thus would choose to keep the adjusted trade and avoid nullification

Day 1

8:00:00 am (pre-market) – Customer A enters order on PHLX to Buy 10 BAC April 7.00 calls for \$.01 (cost of \$10 total. (Customer has \$3,000 in his account).

10:00:00 am

BAC trading \$11

April 7 calls \$4.50-\$4.70 (100x100) on all exchanges

10:04:00 am

BAC Trading \$11

April 7 calls \$.01-\$4.70 (10x10) PHLX

April 7 calls \$4.50-\$4.70 (10x10) CBOE

April 7 calls \$4.50-\$4.70 (10x10) All other exchanges

10:04:01 am

Customer B enters order to sell 10 April 7 calls at \$.01 on PHLX with an ISO indicator (which allows trade through)

10:04:01 am

10 April 7 calls execute at \$.01 on PHLX Customer A buying and Customer B selling.

10:04:02 am (1 second later)

BAC is \$11

April 7 calls \$4.50-\$4.70 (10x10) PHLX

April 7 calls \$4.50-\$4.70 (10x10) CBOE

April 7 calls \$4.50-\$4.70 (10x10)) All other exchanges

No obvious error is filed within 20 minute notification time required by rule. If this had been an obvious error review, the trade would have been nullified.

11:00:00 am

BAC trading \$9.60

April 7 calls \$3.00-\$3.25 (10x10) PHLX

April 7 calls \$3.00-\$3.25 (10x10) CBOE

April 7 calls \$3.00-\$3.25 (10x10)) All other exchanges

Customer A sells 10 April 7 calls at \$3.00 (a total credit of \$3,000 for a \$2,990 profit)

3:00:00pm

BAC trading \$12.80

April 7 calls \$5.80-\$6.00 (10x10) PHLX

April 7 calls \$5.80-\$6.00 (10x10) CBOE

April 7 calls \$5.80-\$6.00 (10x10)) All other exchanges

Customer A has now no position and would be at risk of a loss if nullified.

3:20:00pm

Customer B submits S10 BAC April 7 calls at \$.01 under Catastrophic Error Review.

Trade meets the criteria of Catastrophic Error and is adjusted to \$2.50 (\$4.50 (the 10:04:02 am price) less \$2 adjustment penalty).

Impact:

Under current Rule: Customer A would be adjusted to \$2.50 (\$4.50 (the 10:04:02 am price) less \$2 adjustment penalty).

Under Proposed rule:

Illustrating the need for a choice, Customer A chooses within 20 minutes to accept an adjustment to \$2.50 instead of a nullification, locking in a gain of \$500 instead of \$2,990 (B 10 at \$2.50 vs. S10 at \$3.00).

If not given a choice, Customer A would be naked short 10 calls at \$3.00 that are now offered at \$6.00 (a \$3,000 loss).

These examples illustrate the need for the non-broker dealer customer to have a choice in order to manage his risk. By applying a notification time limit of 20 minutes, it lessens the likelihood that the customer will try to let the direction of the market for that option dictate his decision for a long period of time, thus exposing the contra side to more risk. This 20 minute time period is akin to the notification period currently used in the rule respecting the notification period for starting the obvious error process for member organizations that initiated the order from off the floor of the Exchange (as opposed to on-floor specialists and ROTs).⁶

For a market maker or a broker-dealer, the penalty that is part of the price adjustment process is usually enough to offset the additional dollars spent, and they can often trade out of the position with little risk and a potential profit. For a customer who is not immersed in the day-to-day trading of the markets, this risk may be unacceptable. A customer is also less likely to be watching trading activity in a particular option throughout the day and less likely to be closely focused on the execution reports the customer receives after a trade is executed.

Accordingly, the Exchange believes that it is fair and reasonable, and consistent with statutory

⁶ See Phlx Rule 1092(e)(i)(A).

standards, to change the procedure for catastrophic errors for customers and not for other participants.

The Exchange believes that the proposal is a fair way to address the issue of a customer's limit price, yet still balance the competing interests of certainty that trades stand versus dealing with true errors. When Rule 1092 was first adopted, the Commission stated that it "...considers that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an 'obvious error' may exist, suggesting that it is unrealistic to expect that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an 'obvious error' has occurred, and the adjustment or nullification of a transaction because an obvious error is considered to exist, should be based on specific and objective criteria and subject to specific and objective procedures... The Commission believes that Phlx's proposed obvious error rule establishes specific and objective criteria for determining when a trade is an "obvious error." Moreover, the Commission believes that the Exchange's proposal establishes specific and objective procedures governing the adjustment or nullification of a trade that resulted from an "obvious error."⁷ Since 2004, Phlx has been administering this rule with respect to options trading.

In 2008, the Exchange amended Rule 1092 to adopt the catastrophic error provision. In doing so, the Exchange stated that it had "weighed carefully the need to assure that one market participant is not permitted to receive a windfall at the expense of another market participant that made an Obvious Error, against the need to assure that market participants are not simply being given an opportunity to reconsider poor trading decisions. The Exchange states that, while it

⁷ See Securities Exchange Act Release No. 49785 (May 28, 2004), 69 FR 32090 (June 8, 2004) (SR-Phlx-2003-68).

believes that the Obvious Error Rule strikes the correct balance in most situations, in some extreme situations, trade participants may not be aware of errors that result in very large losses within the time periods currently required under the rule. In this type of extreme situation, the Exchange believes its members should be given more time to seek relief so that there is a greater opportunity to mitigate very large losses and reduce the corresponding large wind-falls. However, to maintain the appropriate balance, the Exchange believes members should only be given more time when the execution price is much further away from the theoretical price than is required for Obvious Errors so that relief is only provided in extreme circumstances.”⁸

The Exchange believes that this proposal is consistent with those principles because it strikes the aforementioned balance. The Exchange is proposing to amend Exchange Rule 1092 to eliminate the risk associated with (non-broker-dealer) customers receiving an adjustment to a trade that is outside of the limit price of their order, when there is a catastrophic error ruling respecting their trade. The new provision would continue to entail specific and objective procedures. Furthermore, the new provision more fairly balances the potential windfall to one market participant against the potential reconsideration of a trading decision under the guise of an error.

The obvious and catastrophic error rules of the options exchanges are similar, especially with respect to only adjusting trades that result in a catastrophic error. Nevertheless, the Exchange believes, based on the aforementioned example and member requests, that this aspect of the catastrophic error process should change, as explained above. The Exchange staff has focused on this particular situation because of a recent catastrophic error ruling that resulted in

⁸ See Securities Exchange Act Release No. 58002 (June 23, 2008), 73 FR 36581 (June 27, 2008)(SR-Phlx-2008-42)(Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Catastrophic Errors).

an appeal pursuant to Rule 1092(f)(iv). On appeal, the committee was concerned whether market participants are aware of how options exchange catastrophic errors are handled and whether the rule should be revisited. Relatedly, members of SIFMA's Options Committee also expressed concern during a recent meeting that this particular outcome may not be appropriate. Accordingly, the Exchange has determined to amend the rule.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act⁹ in general, and furthers the objectives of Section 6(b)(5) of the Act¹⁰ in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general to protect investors and the public interest, by helping Exchange members better manage the risk associated with potential erroneous trades. Specifically, the Exchange believes that the proposal is consistent with these principles because it provides a fair process for customers to address catastrophic errors involving a limit order. In particular, the proposal still permits nullification in certain situations. Further, it gives customers a choice. For two reasons, the Exchange does not believe that the proposal is unfairly discriminatory, even though it offers some participants (customers) a choice as to whether a trade is nullified or adjusted, while other participants will continue to have all of their catastrophic errors adjusted. First, the rule currently differentiates among Participants: the notification period to begin the obvious error process is different for specialists and Registered Options Traders,¹¹ and whether a trade is adjusted or busted also

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ See Rule 1092(e)(i)(A).

differs.¹² Second, options rules often treat customers in a special way,¹³ recognizing that customers are not necessarily immersed in the day-to-day trading of the markets, less likely to be watching trading activity in a particular option throughout the day and may have limited funds in their trading accounts. Accordingly, differentiating among Participant types by permitting customers to have a choice as to whether to nullify a trade involving a catastrophic error is not unfairly discriminatory, because it is reasonable and fair to provide non-professional customers with additional options to protect themselves against the consequences of obvious errors.

The Exchange acknowledges that the proposal contains some uncertainty regarding whether a trade will be adjusted or nullified, depending on whether one of the parties is a customer, because a person would not know, when entering into the trade, whether the other party is or is not a customer. The Exchange believes that the proposal nevertheless promotes just and equitable principles of trade and protects investors and the public interest, because it eliminates a more serious uncertainty in the rule's operation today, which is *price* uncertainty. Today, a customer's order can be adjusted to a significantly different price, as the examples above illustrate, which is more impactful than the possibility of nullification. Furthermore, there is uncertainty in the current obvious error portion of Rule 1092 (as well as the rules of other options exchanges), which Participants have dealt with for a number of years. Specifically, Rule 1092(e)(ii) provides that if it is determined that an Obvious Error has occurred: (A) where each party to the transaction is either a specialist or ROT on the Exchange, the execution price of the transaction will be adjusted by an Options Exchange Official, unless both parties agree to nullify

¹² See Rule 1092(e)(i)(A).

¹³ For example, many options exchange priority rules treat customer orders differently and some options exchanges only accept certain types of orders from customers. Most options exchanges charge different fees for customers.

the transaction within ten minutes of being notified by Regulatory staff of the Obvious Error; or (B) where at least one party to the transaction in which an Obvious Error occurred is not a specialist or ROT on the Exchange, an Options Exchange Official will nullify the transaction, unless both parties agree to adjust the price of the transaction within 30 minutes of being notified by Regulatory staff of the Obvious Error. Therefore, a specialist who prefers adjustments over nullification cannot guarantee that outcome, because, if he trades with a customer, a resulting obvious error would only be adjusted if the customer agreed to an adjustment. This uncertainty has been embedded in the rule and accepted by market participants. The Exchange believes that this proposal, despite the uncertainty based on whether a customer is involved in a trade, is nevertheless consistent with the Act, because the ability to nullify a customer's trade involving a catastrophic error should prevent the price uncertainty that mandatory adjustment under the current rule creates, which should promote just and equitable principles of trade and protect investors and the public interest.

The proposal sets forth an objective process based on specific and objective criteria and subject to specific and objective procedures. In addition, the Exchange has again weighed carefully the need to assure that one market participant is not permitted to receive a windfall at the expense of another market participant that made a catastrophic error, against the need to assure that market participants are not simply being given an opportunity to reconsider poor trading decisions. Accordingly, the Exchange has determined that introducing a nullification procedure for catastrophic errors is appropriate and consistent with the Act.

Consistent with Section 6(b)(8),¹⁴ the Exchange also believes that the proposal does not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act, as described further below.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Currently, most options exchanges have similar, although not identical, rules regarding catastrophic errors. To the extent that this proposal would result in Phlx's rule being different, market participants may choose to route orders to Phlx, helping Phlx compete against other options exchanges for order flow based on its customer service by having a process more responsive to current market needs. Of course, other options exchanges may choose to adopt similar rules. The proposal does not impose a burden on intra-market competition not necessary or appropriate in furtherance of the purposes of the Act, because, even though it treats different market participants differently, the Obvious Errors and Catastrophic Errors rule has always been structured that way and adding the ability for customers to choose whether a catastrophic error trade is nullified does not materially alter the risks faced by other market participants in managing the consequences of obvious errors. Overall, the proposal is intended to help market participants better manage the risk associated with potential erroneous options trades and does not impose a burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

¹⁴ 15 U.S.C. 78f(b)(5).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission shall: (a) by order approve or disapprove such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PHLX-2013-05 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-PHLX-2013-05. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the

proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-PHLX-2013-05 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁵

Kevin M. O'Neill
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).